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INTRODUCTION

In accordance with the City Auditor's 1992-93 Audit Workplan, we have initiated an audit of franchise fees and tax remittances. We conducted this audit in accordance with generally accepted government auditing standards and limited our work to those areas specified in the Scope and Methodology section of this report.

SCOPE AND METHODOLOGY

Our audit scope encompassed the frequency of collection of franchise fees, taxes, and permit revenues collected by the Finance Department, and also the federal and state government employee exemption from transient occupancy taxes (TOT).

Our methodology included interviews with officials from

- the Finance Department;
- the Office of the City Attorney; and
- the Convention, Cultural, and Visitor Services Department.

In addition, we reviewed the *San Jose Municipal Code* sections pertaining to our audit scope and the California State Attorney General opinions on TOT. We also reviewed the 1991-92 TOT returns for the top 25 hotels remitting the highest tax revenues.

We performed telephone surveys and obtained copies of relevant sections of the municipal codes and TOT forms of selected California cities and other major west coast and central cities. Furthermore, we interviewed managers from various San Jose hotels. Finally, we performed telephone interviews with officials from the State Board of Equalization and the Federal Transportation Management Division.

BACKGROUND

During 1991-92 and 1992-93, the City collected the following revenues from franchise fees, taxes, and permits.

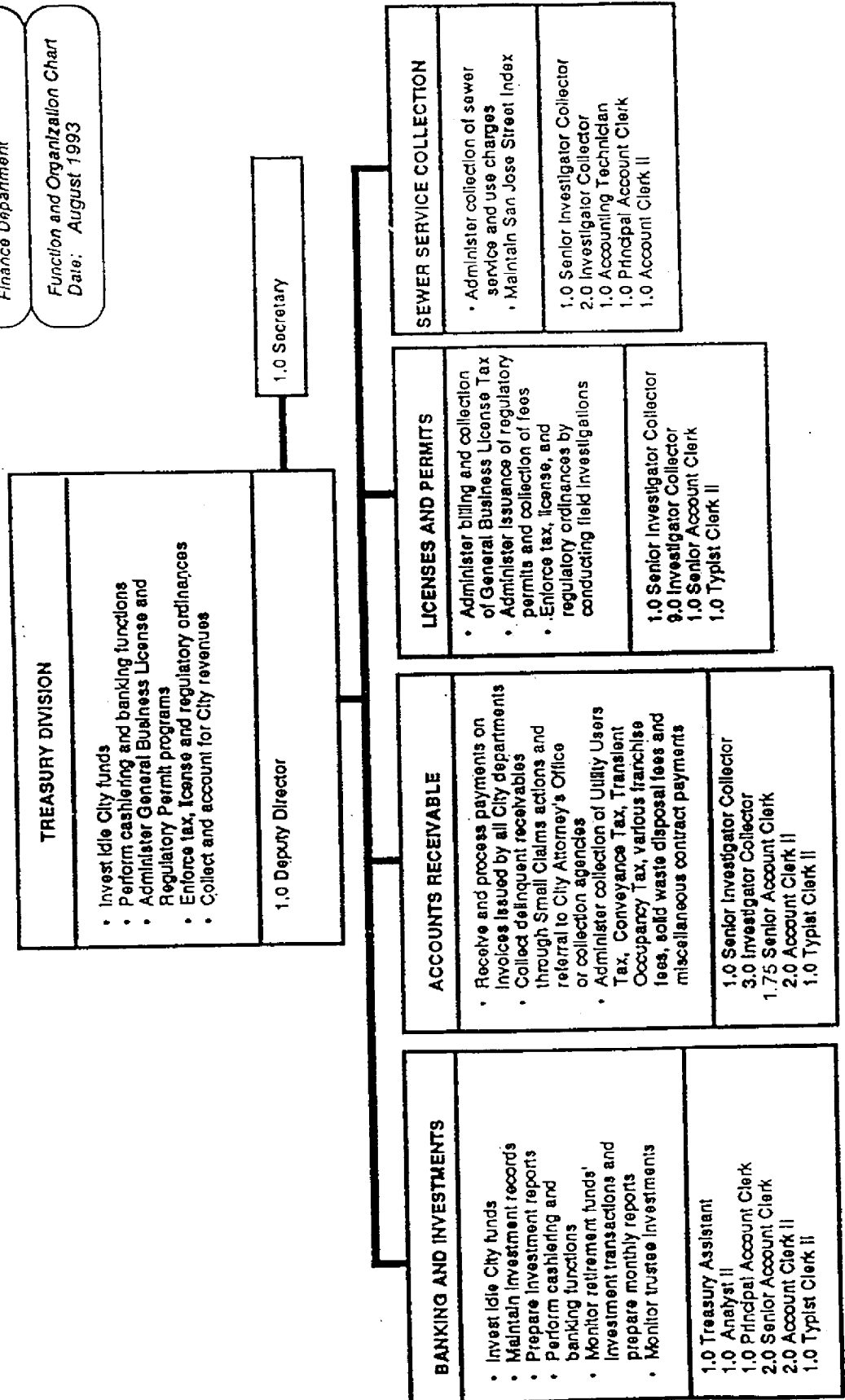
	(In thousands)	
	<u>1991-92</u>	<u>1992-93</u>
Utility Users Tax	\$39,938	\$ 41,183
Garbage Franchise	16,305	23,582
PG&E Franchise	12,117	12,031
Conveyance Tax	10,285	8,984
Business License Tax & Penalties	9,562	10,325
Transient Occupancy Tax	7,220	7,727
Landfill Tax	4,390	16,098
Rubbish Franchise	3,593	4,012
Disposal Fees	3,172	3,173
Cable Television Franchise	2,495	2,648
Residential Occupancy Permits	1,358	1,478
Cardroom Tax	1,091	5,075
Concessions	572	434
Towing Franchise	233	170
Cannery Waste	38	50
Regulatory Permits	<u>21</u>	<u>357</u>
Total	\$112,390	\$137,327

The Finance Department/Treasury Division administers the collection of these revenues. Chart I shows the organization of the Finance Department/ Treasury Division.

CHART I

CITY OF SAN JOSE
Finance Department

Function and Organization Chart
Date: August 1993



Definitions

The meanings of the words "hotel" and "transient" as used in this report are defined in *San Jose Municipal Code*, Section 4.72.020:

"Hotel" means any structure situated in the city, including, but not limited to, any hotel, inn, tourist home or house, motel, studio hotel, bachelor hotel, guesthouse, bed and breakfast inn, apartment house, dormitory, public or private club, mobilehome or house trailer at a fixed location, or other similar structure or portion thereof situated in the city, which is occupied or intended or designed for occupancy by transients for dwelling, lodging or sleeping purposes.

"Transient" means a person who exercises occupancy or is entitled to occupancy by reason of concession, permit, right or access, license, or other agreement for a period of thirty consecutive calendar days or less, counting portions of calendar days as full days."

Program Accomplishments

In Appendix B, the Finance Department informs us of its major accomplishments in the collection of franchise fees, taxes, and permit revenues.

FINDING I

**EARLIER REMITTANCES OF TRANSIENT OCCUPANCY TAXES
AND CABLE TELEVISION FRANCHISE FEES WOULD
PRODUCE A ONE-TIME REVENUE INCREASE
OF \$1.6 MILLION AND INCREASED INTEREST EARNINGS
OF ABOUT \$28,000 PER YEAR**

During 1992-93, the Finance Department of the city of San Jose (City) collected \$137 million from sixteen categories of franchise fees, taxes, and permit revenues, of which twelve are estimated to exceed \$1 million each in remittances. Our review of these twelve franchise fee, tax, and permit categories revealed that

- Seven categories are paid monthly, while five are paid quarterly or less frequently;
- Of the five categories paid quarterly or less frequently, two--transient occupancy taxes (TOT) and cable television franchise fees--are the most susceptible to being paid on a monthly basis; and
- Monthly remittances of TOT and cable television franchise fees would generate a one-time revenue increase for the City of \$1.6 million and annual increased interest earnings of about \$28,000.

Accordingly, by amending the *San Jose Municipal Code* to allow for monthly remittance of TOT and cable television franchise fees, the City would, without incurring additional costs or raising taxes, (1) receive a one-time \$1.6 million revenue increase, (2) increase its annual interest earnings by \$28,000, and (3) reduce the risk of hotels defaulting on paying their TOTs.

Finance Department Revenue Collections

The City's Finance Department collects sixteen categories of franchise fees, taxes, and permit revenues, including the utility user's tax, the landfill tax, the conveyance tax, and the garbage franchise fees. Table I shows the sixteen categories and their frequency of payments.

TABLE I

**AMOUNT AND FREQUENCY OF PAYMENTS OF FRANCHISE FEES,
TAXES, AND PERMIT FEES FOR 1992-93**

<u>Revenues</u>	<u>Amount</u>	<u>Frequency</u>
Utility Users Tax	\$41,183,319	Monthly
Garbage Franchise	23,582,139	Monthly
Landfill Tax	16,097,950	Monthly
PG&E Franchise	12,031,074	Quarterly
Business License Tax & Penalties	10,325,227	Annually
Conveyance Tax	8,983,655	Monthly
Transient Occupancy Tax	7,727,012	Quarterly
Cardroom Tax	5,074,579	Monthly
Rubbish Franchise	4,011,829	Monthly
Disposal Fees	3,173,456	Monthly
Cable Television Franchise	2,648,222	Quarterly
Residential Occupancy Permits	1,478,435	Annually
Concessions	433,820	Monthly/Seasonally
Regulatory Permits	357,052	Annually
Towing Franchise	169,825	Quarterly
Cannery Waste	49,800	Monthly
Total	<u>\$137,327,394</u>	

As shown above, twelve revenue categories exceed \$1 million each per year in remittances, and of those twelve categories, five are remitted quarterly or less frequently. These five categories that remit payments quarterly or less frequently are the business license taxes, TOTs, cable television franchise fees, PG&E franchise fees, and the residential occupancy permit fees. As described below, our review of these five

revenue categories revealed that the TOTs and the cable television franchise fees are most susceptible to being paid on a monthly basis.¹

**TOTs And Cable Television Franchise Fees
Are The Most Susceptible To More Frequent Remittance**

There are two criteria that make it particularly advantageous for the City to consider changing to a more frequent remittance of revenues. The first criterion is that increased revenues arising from accelerated remittances and increased interest earnings will be significant. The second criterion is that there will be little or no additional administrative cost associated with accelerated collections. Our review revealed that both of these criteria apply to the City's TOTs and the cable television franchise fees.

**\$1.6 Million One-Time Revenue Increase
And \$28,000 In Increased Annual Revenues**

Changing the frequency of remittance of TOTs and cable television franchise fees from quarterly to monthly will generate a one-time revenue increase for the City of \$1.6 million and additional annual interest earnings of about \$28,000.

Transient Occupancy Taxes

The TOT is 10 percent of rents paid to hotels (for stays of 30 days or less) and is comprised of two taxes: a 4 percent general fund tax that goes to the City's General Fund and a 6 percent special fund tax that is used to fund

¹ For reasons discussed in Other Pertinent Information, the other three revenue categories--business license taxes, PG&E franchise fees, and residential occupancy permit fees--are not susceptible to being paid on a monthly basis.

the City's Convention and Visitors Bureau, Cultural Grants, Fine Arts Program, and the City's operating subsidy to the convention and cultural facilities. Approximately \$7.2 million in TOTs were collected in 1991-92 and \$7.7 million in 1992-93.

The hotels collect the TOTs from their customers daily. The City presently requires hotels to remit TOTs on a quarterly basis. Specifically, the taxes are due and payable "*on or before the last day of the month following the close of each calendar quarter.*" By requiring the hotels to remit the taxes monthly, the City will gain additional cash flow of \$1.2 million during the first year and additional interest income of \$21,059 starting the first year and annually thereafter. Appendices C-1 and C-2 show our computation of the City's additional cash flow and interest income assuming an interest rate of 3.5 percent. We assumed a 3.5 percent interest rate after reviewing the "closing yields" schedule from the Finance Department/Treasury Division for current yields for new money invested. The closing yields as of July 6, 1993, as disclosed from the Finance Department, for money invested less than two years is as follows:

<u>Time Period</u>	<u>Yields</u>
3 months	3.022%
6 months	3.202%
1 year	3.409%
2 years	3.992%

After reviewing these closing yields and discussing the assumed interest rate with the Finance Department/Treasury Division, we concluded that using a 3.5 percent rate for the interest income calculations is reasonable.

Our survey of other jurisdictions indicates that most of these jurisdictions collect TOTs monthly. Of the twelve cities surveyed, seven (Burlingame, Cupertino, Fremont, Sacramento, San Diego, Inglewood, and Santa Barbara) require their hotels to remit TOTs monthly; three (Milpitas, Santa Clara, and Santa Cruz) have some of their hotels remitting monthly and other hotels remitting quarterly;² one (San Francisco) is in the process of changing its ordinance to require monthly remitting; and only one (Sunnyvale) continues to require quarterly remitting.

We also contacted two major San Jose hotels regarding the change in the frequency of remitting TOTs. The hotels we contacted were not opposed to monthly remitting because they already remit sales taxes monthly³ and their records are on a monthly basis. In fact, one hotel even favored monthly remittance of TOTs because it prefers remitting smaller amounts of money, which monthly payments would allow.

Cable Television Franchise Fees

The cable television franchise fees are 5 percent of cable television gross revenues. The amount collected by the City goes to the City's General Fund. The City has one cable television company that pays the franchise

² The majority of hotels in Milpitas file quarterly. The hotels are given a choice when they register with the city as to the frequency they wish to remit--either monthly or quarterly. In Santa Clara, all the hotels except the largest file quarterly; the largest hotel files monthly. Most of the hotels in Santa Cruz file quarterly; however, the city requires some hotels to remit monthly due to collection problems.

³ The state of California requires businesses that anticipate sales tax accrual above \$250 to remit sales taxes monthly. Hotels that anticipate sales tax accrual above \$1,000 are required to remit sales taxes monthly based on an estimate and to file their sales tax returns quarterly. The two hotels we spoke with remitted their sales taxes monthly.

fee: TCI Cablevision. Approximately \$2.5 million in cable television franchise fees were collected in 1991-92 and \$2.6 million in 1992-93.

TCI Cablevision pays cable television franchise fees in accordance with the City's Ordinance No. 22128. The franchise agreement is effective until January 1, 2001. Although Ordinance No. 22128 does not specifically require quarterly payments, it does refer to the *San Jose Municipal Code*, which currently specifies quarterly payments. According to the City Attorney, the City can request to renegotiate its contract with the cable television franchisee to change the payment frequency from quarterly to monthly.

By requiring TCI Cablevision to remit the franchise fees monthly, the City will gain additional cash flow of \$409,000 during the first year and additional interest income of \$7,278, assuming a 3.5 percent interest rate, starting the first year and annually thereafter. Appendices D-1 and D-2 show our computation of the City's additional cash flow and interest income.

Our survey of other jurisdictions indicates that three of the nine jurisdictions that receive more than \$1 million in cable television franchise fees require monthly remittance. Specifically, the cities of Sacramento (\$1.8 million annually), Dallas (\$2.6 million annually), and Seattle (\$4.5 million annually) require monthly remittance of cable television franchise fees. Furthermore, the city of Phoenix, which receives \$3.3 million annually in cable television franchise fees, is renegotiating its contract, and one of the concessions it is seeking is changing the frequency of remittance from quarterly to monthly. Some comments from the cities that we contacted that are requiring monthly remittance suggested that monthly remittance is

simpler, faster, and allows them to know their revenues each month.

Appendix E shows the results of our survey in detail.

No Increased Administrative Costs

If the TOTs and the cable television franchise fees are remitted monthly, the Finance Department/Treasury Division estimates that there would be some added processing time due to the increased remittance frequency; however, the Division does not estimate it to be a significant increase since it reviews the same number of days regardless of the frequency of remittance. Furthermore, the Division expects that any additional processing time will be offset by the hotels submitting more accurate tax returns.

According to the staffs of the cities that have converted to monthly TOT remitting, more frequent remitting allows them to work in more manageable increments by evening out the workload.

With regard to the cable television franchise fees, TCI Cablevision currently submits the quarterly franchise fee payment with a two-page statement. According to the Finance Department staff, the workload increase under monthly remitting would be insignificant.

Reduced Risk of Default

The practice of remitting monthly reduces the risk of hotels defaulting on their TOTs. In 1991-92, the City had one hotel that failed to remit TOTs from July 1991 through March 1992. The City's Treasury Division has put this hotel on a payment schedule to ensure that all the taxes owed are collected. With a monthly remittance schedule, the City would be alerted to

any payment problem sooner and would be able to take corrective action promptly.⁴

CONCLUSION

During 1992-93, the City's Finance Department collected \$137 million from sixteen categories of franchise fees, taxes, and permit revenues, of which twelve are estimated to exceed \$1 million each in remittances. Our review of these twelve franchise fee, tax, and permit categories revealed that two--transient occupancy taxes and cable television franchise fees--are the most susceptible to being paid on a monthly basis. By amending the *San Jose Municipal Code* to allow for monthly remittance of transient occupancy taxes and cable television franchise fees, the City would, without incurring additional costs or raising taxes, (1) receive a one-time \$1.6 million revenue increase, (2) increase its annual interest earnings by \$28,000, and (3) reduce the risk of hotels defaulting on paying their transient occupancy taxes.

⁴ In collecting sales taxes, the State Board of Equalization puts a defaulting account on a monthly payment schedule, although the account may normally be on a quarterly payment schedule. The Board has found that requiring more frequent payments reduces the amount of uncollectibles.

RECOMMENDATIONS

We recommend that the Finance Department:

Recommendation #1:

Request the City Council to change the frequency of payment of the transient occupancy tax by amending the *San Jose Municipal Code* to require all hotels to remit the transient occupancy tax monthly. (Priority 2)

Recommendation #2:

Renegotiate the franchise agreement with the cable television franchisee to allow monthly remittance of the cable television franchise fees. (Priority 2)

Recommendation #3:

Upon successful renegotiation of the franchise agreement, request the City Council to change the frequency of payment of the cable television franchise fees by amending the *San Jose Municipal Code* to require monthly remittance. (Priority 2)

FINDING II

ELIMINATION OF THE EXEMPTION FOR FEDERAL AND STATE EMPLOYEES WOULD INCREASE TRANSIENT OCCUPANCY TAX REVENUES BY ABOUT \$80,000 PER YEAR

The *San Jose Municipal Code* allows an exemption from paying transient occupancy taxes (TOT) for federal and state employees on official business. Our audit of the city of San Jose's (City) collection of TOTs revealed that

- Most of the cities proximate to San Jose do not exempt federal and state government employees on official business from paying TOTs;
- A recent California State Attorney General's opinion makes it easier for municipalities to eliminate existing federal and state employee exemptions from TOTs;
- Most of the major cities competing with San Jose for conventions either do not exempt federal and state government employees on official business from paying TOTs or significantly restrict the exemption;
- The federal government sets lodging per diem rates for its employees at levels intended to compensate employees for TOTs;
- San Jose's federal lodging per diem rate does not compensate for TOTs; and
- The federal government will increase San Jose's lodging per diem rate to compensate employees for TOTs if San Jose eliminates its federal and state employee exemption.

In our opinion, by amending the *San Jose Municipal Code* to eliminate the federal and state employee exemption from TOTs, the City will

increase revenues by about \$80,000 per year without compromising San Jose's ability to compete with surrounding communities for hotel patrons.

Current Exemption

San Jose is authorized to tax transients per subdivision (a) of Section 7280 of the *Revenue and Taxation Code* which provides in part that

The legislative body of any city or county may levy a tax on the privilege of occupying a room or rooms in a hotel, inn, tourist home or house, motel, or other lodging unless the occupancy is for any period of more than 30 days.

The TOT consists of a 6 percent special fund tax and a 4 percent general fund tax for a total of 10 percent tax charged. The special fund tax funds the following as outlined in *San Jose Municipal Code*, Section 4.72.065, "Use of tax revenue-Deposit in special fund":

B. All of the taxes collected under this chapter shall, subject to the provisions hereinafter set forth, be expended for the following:

1. Funding of a convention and visitors bureau for the city of San Jose, including a rental subsidy of city facilities for convention purposes.

2. Funding of the cultural grant program and fine arts divisions programs, including:

a. Funding of cultural grants, including the San Jose Symphony and the San Jose Museum of Art, and a rental subsidy for cultural use of city facilities; and

b. Funding the expenses of the fine arts division of the convention and cultural department, including but not limited to personal, nonpersonal, and equipment expenses, fringe benefits, and overhead.

3. Funding of the city's operating subsidy to the convention and cultural facilities of the city of San Jose.

San Jose Municipal Code, Section 4.74.020, indicates that the general fund tax shall be deposited in the General Fund of the City.

The City currently allows an exemption for federal and state government employees on official business in accordance with *San Jose Municipal Code*, Section 4.72.030 (special fund tax) and Section 4.74.040 (general fund tax):

Exemptions

- A. *No tax shall be imposed upon:*
 - 1. *Any federal or state officer or employee when on official business;*
 - 2. *Any officer or employee of a foreign government who is exempt by reason of express provision of federal law or international treaty.*
- B. *No exemption shall be granted except upon a claim therefor made at the time rent is collected, and under penalty of perjury, upon a form prescribed by the director of finance.*

Appendix F shows a photocopy of the City's exemption claim form.

After the passage of Proposition 13, certain types of changes to special fund taxes must be approved by two-thirds of the voters. Elimination of the federal and state government employee exemption for the special fund portion of the TOT would arguably require two-thirds voter approval. The City could include such a measure with the primary election in June 1994. By including the measure with a regularly scheduled election, the cost of placing the measure on the ballot will be minimal. If the measure is approved, then the City Council could amend the *San Jose Municipal Code* to eliminate the federal and state government employee exemption for the general fund portion of the TOT.

Survey Of Other Proximate Jurisdictions

We surveyed municipal jurisdictions proximate to San Jose regarding their federal and state government employee exemption policies. We also obtained copies of their TOT municipal code sections, TOT rates, and forms. Our survey revealed that three of the five cities did not provide the exemption. The individual city survey results are as follows:

<u>City</u>	<u>Federal And State Employee Exemption</u>	<u>TOT Rate</u>
Santa Clara	No	9.5%
Sunnyvale	No	8%
Santa Cruz	No	10%
Milpitas	Yes	8%
Cupertino	Yes	10%

Santa Clara

Santa Clara has not provided the federal and state employee exemption since 1967. Santa Clara's municipal code documents this practice. Furthermore, the Santa Clara Transient Occupancy Tax Return specifically states in the exemption section that "*CITY, COUNTY, STATE AND FEDERAL EMPLOYEES ARE **NOT** EXEMPT FROM THIS TAX.*"

Sunnyvale

Beginning on July 1, 1993, Sunnyvale no longer accepts federal and state government employee exemptions. Sunnyvale previously did allow the exemption if the room rental was paid with a government-issued check. However, Sunnyvale changed its municipal code subsequent to the issuance of the 1992 California State Attorney General opinion on TOTs (see discussion of opinion in following section). Because Sunnyvale's TOT is a general fund tax, Sunnyvale did not require voter approval for the change.

In May 1993, Sunnyvale notified the hotels located within the city that beginning July 1, 1993, the city will no longer allow federal and state government employee exemptions. The Sunnyvale hotels complained about the change because neighboring jurisdictions, such as San Jose, grant the exemption.

Santa Cruz

Santa Cruz allowed the federal and state government employee exemption until June 1992. Santa Cruz allowed this exemption as a matter of practice but did not document it in its municipal code. After the 1989 earthquake, Santa Cruz received an excessive amount of exemption claims and noted many errors and invalid exemptions. Santa Cruz officials researched their municipal code and discovered that the exemption was not documented. In June 1992, Santa Cruz discontinued allowing the federal and state government employee exemption.

Milpitas

Milpitas exempts city, county, state, and federal employees on official business. Milpitas' municipal code shows that only federal and state employees are exempt.

Cupertino

Cupertino exempts federal and state employees on official business. Cupertino's municipal code documents this practice.

California State Attorney General Opinions

The State Attorney General issued opinions regarding the TOT in 1965 and 1992.

Attorney General Opinion 65-99 dated July 20, 1965, was issued in response to the question:

Are officers and employees of the of the United States and the State of California and political subdivisions of the state, while travelling on official business for their respective employing agencies and receiving reimbursement therefrom for their travelling expenses, subject to transient occupancy taxes imposed by counties or cities of this state upon any person occupying space in any hotel or motel for a period of thirty days or less for the privilege of such occupancy?

The opinion concludes that

Officers of the United States, the State of California, or agencies and instrumentalities or political subdivisions thereof are neither immune nor exempt from local transient occupancy taxes where the employing agency reimburses them for their expenses, whether such reimbursement is in the form of a per diem, is based on mileage or is in accordance with the actual expense incurred.

Part of the analysis of the opinion states:

Applying the principles expressed in the "Graves" case to the situation at hand it appears that both federal and state officers are subject to local transient occupancy taxes while travelling on official business where they receive reimbursement for travel expenses, either in the form of a per diem allowance, a mileage allowance, or in the amount of specific expenditures. In each case, the tax is on the individual officer or employee and not on the United States or the State of California. Immunity in this situation would make as little sense as exempting a meal served by a restaurant from the sales tax just because it is eaten by a federal employee while on official business. Clearly, such meal would not be exempted from the sales tax on the basis of the immunity of the national government itself.

Attorney General Opinion 91-1210 was issued May 7, 1992, because the 1965 opinion did not specifically address direct payment by the government

agency. Many California cities allowed the government exemption only when a government agency made direct payment for an employee's hotel room. The State Attorney General issued the 1992 opinion in response to the question:

May a city levy a transient occupancy tax upon a state employee who, while on state business, contracts for a hotel room and submits payment for the room with a state issued check?

The opinion concludes that

A city may levy a transient occupancy tax upon a state employee who, while on state business, contracts for a hotel room and submits payment for the room with a state issued check.

The 1992 opinion states regarding the 1965 opinion that

. . . we concluded that federal, state, and local officials, while traveling on official business, would be subject to what is commonly termed a "transient occupancy tax" regardless of the fact that their employing agency reimbursed them for travel expenses, whether in the form of per diem, mileage, or in accordance with the actual expenses incurred. We left open the question, however, whether a different conclusion would be reached if, in addition, payment would be made by the government agency itself. . . .

We are now presented with that question: is there a different result when the official enters into the rental agreement and submits payment for the room with a state issued (or other governmental) check? We conclude that the result would be the same irrespective of the source of the payment.

The 1992 opinion further states:

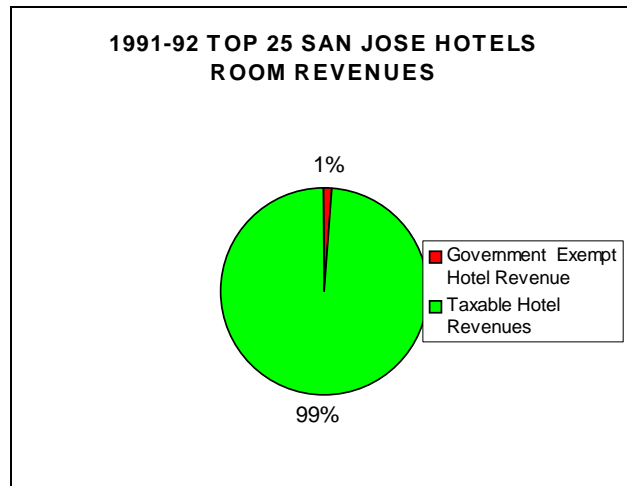
Accordingly, we reject the argument that the election by a governmental agency to advance the room rental charges incurred by its employees while on official business transmutes a local transient occupancy tax into a direct tax on the government. In our view, the tax remains on the employee for "the privilege of occupying a room." . . . It is the employee who is the contracting party and obligated to make payment. Under such circumstances, it cannot be said that the "legal incidence" falls upon the governmental agency at the time the check is tendered. . . .

Thus, elimination of the federal and state government employee exemption allows San Jose to conform to the opinion of the State Attorney General.

The opinion states that the local municipalities can tax federal and state government employee room rentals when on official business. However, the opinion also affirms that government entities cannot be taxed. Therefore, rooms rented and paid for in the name of a government agency and paid for directly by a government agency cannot be taxed. Most of the cities in our survey agree with this concept. Thus, we are recommending modifying the exemption language to include a phrase that shows exemption of tax to "*. . . any occupancy as to which it is beyond the power of the city to impose this tax. . .*"

Calculated Increased Revenues

For tax year ending June 30, 1992, the City collected \$7.2 million in TOTs from 77 establishments based on approximately \$72 million in taxable room revenues. The top 25 hotels remitting the highest tax revenues remitted 90 percent, or \$6.5 million, of the tax collected based on approximately \$65 million in taxable revenues. Total government-exempted revenue for the top 25 hotels was \$848,604, and the tax exempted was \$84,860.



As shown in the previous chart, government-exempted revenue represents approximately one percent of total hotel room revenues after exclusions. (Revenue for stays over 30 days is excluded from taxable revenue.) Although the government-exempted revenue includes exemptions for foreign government officers or employees who are exempt by reason of express provision of federal law or international treaty, we estimate that the foreign government exemptions do not represent a significant portion of the tax. Thus, if the City eliminates federal and state government exemptions, then it should increase annual revenues by approximately \$80,000.

Impact on Hotel Patronage

Hotel Convention Business

Elimination of the federal and state government employee exemption could impact the City's hotel businesses. We discussed the implications of eliminating the exemption on the hotel convention business with the City's

Assistant Director of Convention, Cultural and Visitor Services. According to the Assistant Director of Convention, Cultural and Visitor Services, San Jose has not hosted state and federal governmental conventions, but it does get a significant number of government attendees at high technology and other conventions including such events as the Solid Waste Association of North America, National Recreation and Park Association, and others. He also stated that since government exemptions are such a small part of total hotel revenue, he did not think that eliminating the government exemption would affect a nongovernment convention choosing San Jose for its site. The Assistant Director further added that our competitors for hotel convention business are San Francisco, Los Angeles, San Diego, Seattle, Anaheim, Portland, Denver, Phoenix, and Long Beach. He suggested that an analysis of the impact on hotel convention business should consider the exemption policies of those cities.

We surveyed these cities and asked if they allow federal and state government employee exemptions and what their TOT rates are. The results are as follows:

<u>City</u>	<u>Federal And State Government Employee Exemption</u>	<u>TOT Rates</u>
Anaheim	No	13%
Denver, Colorado	No	11.9%
Phoenix, Arizona	No	4.2%
San Francisco	Direct Government Payment Only	12%
San Diego	Direct Government Payment Only	9%
Los Angeles	Yes	14%
Long Beach	Yes	12%
Seattle, Washington	Direct Federal Government Payment Only	9%
Portland, Oregon	Federal Government Employees Only	9%

- The city of Anaheim discontinued its federal and state employee exemption in July 1992 because of the opinion issued by the State Attorney General. Because Anaheim's TOT is a general fund tax, Anaheim did not require voter approval for the change.
- San Francisco's municipal code does not document an exemption for federal and state employees on official business from TOTs. However, in practice, the hotel tax statement allows an exemption for "Rent for Occupancy by Government Employees Paid by Government Checks." According to a San Francisco audit official, because the city restricts the exemption by requiring direct government payment, the amount of exemptions granted are significantly limited because most traveling government employees are on per diem.
- San Diego also significantly restricts the exemption. The exemption is allowed only when room rental is paid directly with a government check or credit card issued in name of the government agency.

The results of the survey indicate that most of the cities either do not allow the exemption or significantly restrict its use. Thus, elimination of the exemption should not affect San Jose's competitiveness with respect to this particular issue.

San Jose Hotels' Responses To Exemption Elimination

The hotel managers for two San Jose hotels initially indicated opposition to elimination of the exemption because the hotels want to have every competitive advantage to increase business. In addition, one of the hotel managers indicated that the hotel sets its government rate according to the established federal lodging per diem rate. Thus, if the City eliminated the exemption, then the hotel would need to decrease its government room

rate to stay within the federal lodging per diem rate. However, if the City eliminated the exemption and the federal government increased the lodging per diem rate to include the tax, then the hotel could maintain its current government room rate. In that case, the hotel manager indicated the hotel will not oppose the elimination of the exemption. (See additional discussion in the following Federal Government Lodging Per Diem Rates section.) The controller for another hotel favored elimination of the exemption because it reduces paperwork required for processing the exemption. In our opinion, elimination of the exemption should not adversely affect any hotel because (1) San Jose can obtain an increase in the per diem rate to cover the tax; (2) major and neighboring cities have the same or similar policies; and (3) government exemptions represent such a small portion of the hotel business.

Federal Government Lodging Per Diem Rates

According to an April 1990 fact sheet issued by the U.S. General Services Administration Federal Supply Service regarding federal employees' liability for local taxes charged by hotels, "INDIVIDUAL FEDERAL EMPLOYEES GENERALLY ARE REQUIRED TO PAY STATE AND LOCAL LODGING TAXES INCURRED DURING OFFICIAL TRAVEL." The fact sheet further states that "*Per diem rates are set at levels intended to compensate employees for these taxes*" and "*The number of locations that offer specific exemptions to individual Federal employees is quite small.*"

The U.S. General Services Administration Federal Supply Service, Transportation Management Division, contracts to have lodging per diem rates for all locations reviewed at least annually. The contractor reportedly

bases the rates on two- and three-star hotel rates for the key city in an area. The review process allows for recommended rate adjustments as appropriate. The Transportation Management Division submits the recommendations to the U.S. Office of Management and Budget for approval. Rate changes usually become effective in January of each year.

The U.S. General Services Administration lists per diem maximum lodging amounts for federal employees in the *Federal Register*. According to the March 1993 *Federal Register*, the lodging per diem rate for all cities in Santa Clara County is \$65. The *Federal Register* identifies San Jose as the "key city" in the County. Following is a comparative listing of per diem rates for selected California counties:

<u>California Counties</u>	<u>Lodging Per Diem Rates</u>
Los Angeles	\$102
Orange (Anaheim)	\$102
Ventura	\$102
Kern (Bakersfield)	\$102
San Francisco	\$96
Santa Cruz	\$77
San Diego	\$77
Monterey	\$77
Alameda (Oakland)	\$71
Contra Costa	\$71
Marin	\$71
Sacramento	\$67
Santa Clara (San Jose)	\$65
Fresno	\$62

Note: The *Federal Register* lists Los Angeles as the "key city" for Los Angeles, Orange, Kern, and Ventura counties. It also lists Oakland as the "key city" for Alameda, Contra Costa, and Marin counties.

As shown above, San Jose's lodging per diem rate is lower than most major California cities. According to the Transportation Management Division program analysis branch chief in charge of the per diem rate-setting

process, San Jose's lodging per diem rate does not include TOT because San Jose currently exempts federal employees from TOT. The branch chief added that if San Jose's exemption is eliminated, then Santa Clara County's lodging per diem rate will be increased to include San Jose's TOT rate. Thus, based on the present lodging per diem rate of \$65, the lodging per diem rate would increase to \$71.50. The rate increase can be coordinated by San Jose's Office of Intergovernmental Relations Washington liaison to be effective the following January.

CONCLUSION

San Jose allows federal and state government employees an exemption from paying TOTs. Our survey of neighboring jurisdictions revealed that most of these cities do not allow this exemption or are in the process of eliminating the exemption. Our survey of major cities competing for convention business also showed that most of them either do not allow the exemption or significantly restrict its use. In addition, the California State Attorney General's opinions on domestic government exemptions from TOTs support the elimination of the exemption from TOT. Furthermore, the federal government sets lodging per diem rates to include local TOTs. However, San Jose's lodging per diem rate does not include TOTs. The federal government will increase San Jose's lodging per diem rate if the federal and state exemption is eliminated. Finally, by eliminating the federal and state exemption from TOT, the City will increase revenues by about \$80,000 without compromising San Jose's ability to offer competitive rates when compared to major and neighboring cities.

RECOMMENDATIONS

We recommend that the City Council:

Recommendation #4:

Direct the City Attorney to draft an ordinance to change *San Jose Municipal Code*, Section 4.72.030, "Transient Occupancy Tax-special fund," effective January 1, 1995, to amend subsection 1 to read as follows and submit it for voter approval:

4.72.030 Exemptions.

A. *No tax shall be imposed upon:*

1. Any person as to whom or any occupancy as to which it is beyond the power of the city to impose this tax.

2. Any officer or employee of a foreign government who is exempt by reason of express provision of federal law or international treaty.

B. No exemption shall be granted except upon a claim therefor made at the time rent is collected, and under penalty of perjury, upon a form prescribed by the director of finance.

Deleted: *1. Any federal or state officer or employee when on official business;*

(Priority 2)

Recommendation #5:

Upon successful implementation of Recommendation #4, direct the City Attorney to draft an ordinance amending *San Jose Municipal Code*, Section 4.74.040, "General Fund Transient Occupancy Tax--Exemptions," to eliminate the federal and state employee exemption from transient occupancy tax and submit it to City Council for adoption. (Priority 2)

Finally, we recommend that San Jose's Office of Intergovernmental Relations:

Recommendation #6:

Upon successful implementation of Recommendations #4 and #5, coordinate with the U.S. General Services Administration Transportation Management Division to increase the federal lodging per diem rate for San Jose by 10 percent. (Priority 2)

OTHER PERTINENT INFORMATION

Finance Department Revenue Collections

The three revenue categories exceeding \$1 million each from which the city of San Jose (City) receives revenue quarterly or less frequently that are not susceptible to remitting on a monthly basis are the business license taxes, PG&E franchise fees, and the residential occupancy permit fees. The business license taxes and the residential occupancy permit fees are based on when the license or permit is issued or renewed. However, the transient occupancy taxes (TOT), the cable television franchise fees, and the PG&E franchise fees are based on cash revenues that occur continuously and are collected from customers (daily by hotels for TOTs and monthly by PG&E and cable television franchise fees). Since the City's business license taxes and the residential occupancy permit fees are not based on a continuous stream of revenues, these fees are not as susceptible to more frequent payments.

Regarding the PG&E franchise fees, both Ordinances 21676 and 21677 for distribution of gas and electricity specifically waive negotiation and arbitration of franchise fees until the year 2001. For this reason, even though the City bases the gas and electric franchise fees on ongoing revenues of the organization, the PG&E franchise fees are not as susceptible to monthly remitting.

Business License Tax

Chapter 4.76 of the *San Jose Municipal Code* discusses business license taxes. As defined in this section of the *Code*, business license tax ". .

. *shall mean the tax due for engaging in business in San Jose.*" The City bases the business license tax on the number of employees in the business. The minimum charge is "*one hundred fifty dollars per year, plus an additional tax of eighteen dollars per employee based on the average number of employees over eight employees, not to exceed a maximum of twenty-five thousand dollars.*" The City also bases business license taxes on other than the average number of employees, such as square feet. Businesses pay the business license tax when they first start their businesses, and they renew it annually.

Residential Occupancy Permit

Part 8 of Chapter 17.20, "Housing," of the *San Jose Municipal Code* discusses the residential occupancy permit requirement. Basically, any owner of a building that is used for the following purposes ". . . *shall obtain a residential occupancy permit . . .*": Apartment houses; emergency residential shelters; guest houses; motels/hotels; residential care facilities for seven or more persons; residential service facilities; and fraternity and sorority houses. The residential occupancy permit is \$18 per unit and is paid when the permit is issued and requires annual renewal.

PG&E Franchise Fees

The City's utility franchise agreements require PG&E to remit quarterly 2 percent of its gross receipts. PG&E pays the City 2 percent of gross receipts during each calendar year for "*an indeterminate franchise for transmitting and distributing electricity within the City of San Jose . . .*" This also would apply to the distribution of gas. For the fiscal year ending

June 1992, the City received \$12,117,475 in PG&E franchise revenues. This amount represents 10.8 percent of the total funds the Finance Department received from franchises, taxes, and permits for this same year. By requiring PG&E to remit funds monthly, the City would gain additional cash flow of \$2 million the first year and \$35,343 of additional interest income annually. However, the City's agreement with PG&E specifically waives the right to negotiate the contract until 2001.

The agreement states that the amount of "*annual compensation, and/or the formula or measure or manner in which the amount shall be determined, may be changed or amended . . . within the last six (6) calendar months of the calendar year 2001 . . .*" For this reason, the PG&E franchise fee is not susceptible to monthly remitting.

The above agreement notwithstanding, the City Attorney's Office told the City Auditor's Office that any contract can be renegotiated. Accordingly, in our opinion, the Finance Department should meet with PG&E officials to assess PG&E's willingness to accelerate its payment of franchise fees.

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